Summary of Local Government Fiscal Framework Public Hearings June 2012

For an Equitable Sharing of National Revenue

18 July 2012

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1. Introduction

On 4–5 June 2012, the Financial and Fiscal Commission (the Commission) hosted its second set of public hearings on the Local Government Fiscal Framework (LGFF) at the Leriba Lodge, Centurion, Tshwane, Gauteng. As a basis for these discussions, the Commission's research team had released an analysis of options for improving the effectiveness of the LGFF based on a problem statement, which had been validated by stakeholders at the previous public hearings in October 2011. Stakeholders at the June public hearings gave presentations in response to the Options Analysis.

This document is a summary of some of the key themes that emerged from submissions and group discussions of the 66 stakeholders represented at the second public hearing, and not those of the Commission. It includes consolidated views on the options presented and the outcomes of breakaway groups that examined four areas: (1) Local Government Equitable Share and Conditional Grants, (2) Municipal Own Revenue and Debt Financing, (3) Intergovernmental Interface, Regulation and Monitoring, and (4) Differentiation and Local Government Data. The Commission will in due course release a more comprehensive document outlining in greater detail stakeholder perspectives articulated at the hearings, as well as its own recommendations.

2. Local Government Context

Stakeholders agreed that municipal performance in South Africa is highly variable and that municipalities are confronting many challenges. Larger municipalities (that supply electricity) are under pressure from rapidly increasing bulk electricity and water costs, which means that they receive less income (historically municipalities have used surpluses on their electricity and water accounts to cover general expenditure). Furthermore, they are taking more responsibility for public transport and housing services and have to deal with 'unfunded mandates', providing primary health care, libraries and housing-related services. For rural municipalities, their own-revenue sources are limited, as they do not provide electricity (done by Eskom), water or sanitation services (done by the district municipality), while rates are not payable for land under communal tenure. All municipalities are facing escalating capital expenditure costs because of the need to maintain/build new infrastructure, to reach households in remote areas and to provide higher service levels.

Stakeholders recognised that in less than a decade, municipalities have had to manage the implementation of onerous legislation, including the Municipal Finances Management Act, the Municipal Properties Act, the Municipal Systems Act and the Division of Revenue Act. Major changes in budget reforms and accounting standards have added to the burden of municipalities, and the cost of complying with the laws and regulations governing the LGFF has increased substantially.

Some stakeholders pointed out that the current structure of local government, with two tiers outside the metros, is not yet functioning. Concerns raised included the role of district municipalities (are they providing value for money?) and the role of national departments in supporting local government (e.g. poor intergovernmental coordination and slow progress on various policies, including housing accreditation and transport).

3. The LGFF

Stakeholders proposed a broader definition and criteria for the LGFF. The LGFF definition included in the Options Analysis refers only to transfers, rather than to all municipal revenue, i.e. own revenue (which makes up to 75% of the total LGFF), borrowing and transfers (relative to aggregate expenditures). Stakeholders agreed to use this broader definition in future. The five principles presented in the Options Analysis also need to be expanded (as they are relevant to the local government equitable share, which is much narrower than the overarching local government fiscal framework) and tied more closely to the seven principles contained in the Local Government White Paper (1998), which are still remarkably relevant.

Stakeholders cautioned against expecting too much from a redesigned LGFF, as a lot of other work (e.g. capacity building and support) is required to improve local government functionality. Changes to the fiscal framework can achieve only so much, and effective implementation is still needed at local government level. Therefore, any future devolution of fiscal powers should be informed by functional assignments – the "funding must follow function" concept, so long as the core principles, such as transparency, of the fiscal framework are not compromised. Functions (of, for example, district municipalities) must be clarified before making any changes to grants, such as the Regional Services Council (RSC) levies replacement grant. A revised LGFF might also include performance issues such as capacity training and human resources ("the right people in the right jobs") and systems (e.g. pre-paid water metres and cost management). Furthermore, a revised LGFF must be adaptable to varying municipal contexts and allow for the wide economic, social and spatial differences among municipalities.

The gap-filling and performance-driven approaches were discussed as options for the LGFF structure, although some stakeholders advocated a hybrid approach wherein the appropriate approach would be determined by the circumstances.

4. Gap-filling approach

The gap-filling approach emphasises designing transfers that fill gaps in financing a municipality's operating and capital expenditure and is very similar to the current system. Some stakeholders felt the local government equitable share (LGES) adequately fills the operating accounting gap, but distribution across municipalities needs to be optimised. Other stakeholders were of the view that the LGES is inadequate to cover operating expenditure. Related to this is the lack of linkage between 15 years of capital (grant-financed) infrastructure programmes and the impact on operating expenditure in the LGES.

All categories of municipalities are facing shortages of capital funding, which is hindering their ability to clear service provision backlogs and rehabilitate ageing infrastructure. One explanation given for this persistent gap was insufficient transfers and an inability to raise sufficient debt finance. Another factor suggested was that tariff, subsidy and payment levels and their relative importance vary across municipalities. An important concern raised was the lack of a comprehensive report on what conditional grants have achieved since inception and what informs the annual amendments.

From 2013/14, a new LGES formula will be phased in, which will be clearer and simpler, improve transparency, be more responsive to changes (e.g. migration), and differentiate better among municipalities. However, some stakeholders suggested that more work is needed to understand the operating costs better and to assess fiscal capacity in relation to fiscal effort.

5. Performance-drive approach

A performance-based approach emphasises incentives and requires a mix of interventions, including supporting good governance and management, consumer action with a 'social compact', regulation, benchmarking and incentive-based transfers. Stakeholders agreed that the current grant system does not foster performance, as municipalities receive grant allocations irrespective of how efficient or effective their spending – funding is forfeited only if it is not spent. Larger municipalities (in particular metros) fund a significant proportion of their operations from own revenue, which creates a natural incentive: good performance leads to increased revenue or reduced expenditure, e.g. improved water service delivery leads to cost savings. Many stakeholders expressed the view that all municipalities should ideally fund their operating expenditure from own revenues. In contrast, incentives in capital grants are needed to encourage innovations that will yield future benefits but require huge investments now (e.g. climate change resilience measures). Stakeholders debated whether municipalities should be rewarded for simply carrying out their mandates. The issue of perverse incentives and bail-outs was raised: the intergovernmental fiscal relations (IGFR) system is built on the principle of no bail-outs, but in practice some municipalities (such as metros) are bailed out because they are considered too big to fail (or for political expedience), which is, in effect, rewarding failure. Stakeholders agreed that officials need to be held accountable and that bail-outs can be prevented through provincial and national monitoring and early intervention. An example given was the City of Tshwane, which found over a billion rands of savings within six months.

Some stakeholders cautioned against including incentives in grants because of the Expanded Public Works Programme (EPWP) experience. They pointed out that incentive grants can help well-functioning municipalities to perform even better but will not work in weak, smaller municipalities with backlogs. Such grants can result in negative incentives: municipalities that are overly dependent on transfers from national government may have no incentive to deliver good services, as they are answerable to national government agencies rather than to their residents.

The discussion about incentives also examined how incentives actually work and how they should ideally work, and what should be incentivised. For instance, should municipalities be rewarded for introducing creative innovations that result in a loss of income? One example would be improved demand management that results in lower water and electricity sales.

6. The LGES and Conditional Grants

Municipalities that are alike – for example rural municipalities with similar levels of households and poverty – can have markedly different revenue and expenditure performances. Therefore, stakeholders felt that the LGES discussion needs to move from a context-related to a performance-related focus. Although benchmarking can help in this process, the data used for the LGES needs to be updated more frequently than every ten years (between censuses). Rapid migration and urbanisation substantially affects the municipal delivery context and, hence, the pressures on the LGFF throughout a decade.

Stakeholders were of the view that the LGES needs to be more transparent, fund a minimum efficient municipal structure (not a bloated bureaucracy), and be biased towards small municipalities and those unable to raise their own revenue. The institutional (*I*) component is inadequately funded, which means many municipalities use the basis service component (*BS*) to fund their administration. The institutional (*I*) component should be used for building systems and, even if the development (*D*) component is not active, government needs to ensure that other grants are meeting the objectives of the *D* component i.e. supporting the developmental role of municipalities.

Stakeholders agreed that the proliferation of grants and grant dependency need to be avoided. The municipal infrastructure grant (MIG) should be aligned to other infrastructure grants in order to have a greater impact. For example, MIG allocations could be aligned to housing policy where housing subsidies exclude the funding of internal infrastructure. Some grants may be suitable for integration into the MIG, for example the Integrated National Electricity Programme grant (currently a separate grant), while public transport subsidy grants (for example to the Passenger Rail Agency of South Africa – PRASA) need to be part of the LGFF. Rural road asset management grants should also be factored into the MIG, and confusion around the classification of roads (provincial versus municipal) sorted out. Spatial development could be promoted through an urban settlement development grant, although the neighbourhood development grant has had a poor uptake, which may be because its purpose and how it fits into the LGFF are unclear.

An analysis of recipient municipalities found that capacity grants are not targeting the most appropriate beneficiaries i.e. the least capacitated municipalities. It is necessary to understand clearly the type of required capacity building, in terms of training, systems, financial capacity, implementation capacity and qualifications specific to local government.

7. Municipal Own Revenue and Debt Financing

One proposal for improving municipal fiscal effort is through smart and pre-paid metering, which would reduce the problems with collecting debt. Stakeholders felt that Eskom's role needs to be reviewed, in particular how the institution prevents municipalities from using electricity as a leverage to regulate non-compliance, and how small municipalities with small load factors are being penalised. Further research is needed to assess the implementation of the Commission's previous recommendations, such as better reporting on conditional grants, devolution of housing and transport etc. Policies for providing free basic services should be able to distinguish between those who can, and those who cannot, pay. Given the huge cost of maintaining indigent registers, the line between affordability and social responsibility also needs to be drawn.

The view expressed was that the fuel levy is an unconditional grant and should be spread more broadly, beyond metros, and be spent on transport and roads-related expenditure. However, research is needed to assess the extent to which smaller municipalities can benefit from the fuel levy. Work on development levies and local business tax is currently underway.

One perspective was that debt finance regulations should allow for foreign investment and strict use of local currency. Municipalities should be encouraged to borrow sustainably for funding capital projects, to generate income and become self-sustaining, and to ensure that funds are used for their intended purpose. Stakeholders suggested ways of encouraging lenders to lend, for example incentivising creditworthiness and providing guarantees from institutions to improve credit rating. The view expressed was that the Development Bank of Southern Africa's mandate should be extended so that smaller municipalities can be assisted.

A major issue raised was the insufficient spending by municipalities on repairs and maintenance (R&M). A national infrastructure asset register is the first step, so that the extent, ownership and value of assets can be known. This will enable municipalities to plan their R&M better and national government to know where to allocate grants. Investing in maintenance should be incentivised. To make GRAP 17[1] a national project would be expensive, and so research is needed to determine what measurement to use and what capacity and capabilities exist within the sphere. Linked to this is the need for sufficiently qualified people and oversight by professional institutions.

8. Intergovernmental Interface, Regulation and Monitoring

The norms and standards are set in sector and sphere-wide legislation but are not uniform. They should be flexible and promote transparency and accountability. Stakeholders raised the issue of aligning monitoring and evaluation (M&E) across government, ensuring that critical and relevant

[1] GRAP 17 prescribes the accounting treatment for property, plant and equipment so that the users of financial statements can discern information about an entity's investment in its property, plant and equipment and the changes in such investment. The principal issues in accounting for property, plant and equipment are the recognition of the assets, the determination of their carrying amounts and the depreciation charges and impairment losses to be recognized in relation to them."
Source http://download.asb.co.za/download/GRAP%2017_vs_IAS_16_Sept07.pdf

information is stored and shared. Any M&E also needs to relate closely to local government's key priority issues and objectives.

Oversight is instrumental at each sphere but is weak. At local government level, the role of councillors and the political/administrative interface need strengthening. Public participation, through non-governmental organisations (NGOs) and community-based organisations (CBOs) can assist this accountability. The oversight of provincial legislatures is uneven, while national intervention emphasises financial accountability over service delivery accountability. The suggestion was to focus more on ensuring institutionalised and stable governance systems and structures that drive oversight.

Regulation may not always be necessary to guide the system, especially when the transaction and compliance costs are high. Before introducing regulation, some stakeholders proposed that a regulatory impact assessment should be carried out.

Stakeholders felt that the continuing ambiguity on the roles and functions of local and district municipalities hinders governance and delivery, and creates unfunded mandates. District municipalities should return to their original role of coordination. A review is needed to remove ambiguity and define/assign functions more clearly, in particular the built environment functions.

9. Differentiation and Local Government Data

The context and impacts are different among municipalities, for example the demand for services (which includes the effect of migration), the ability to pay, and the unit cost of delivery (especially rural versus urban municipalities). Measuring these differences requires updated data. Statistics South Africa (StatsSA) plays an important role in providing updated information, and how to update and share data needs to be agreed. Instead of bemoaning data requirements, the system can be designed to economise on data collection costs, for instance introducing local government data centres and sharing information systems (social grants, the basic education learner unit record information tracking system – LURITS).

The issue of capacity at local level is an important one and must be linked to accountability. While the emphasis is usually on individuals, capacity building should also include organisational strengthening through improving billing and metering systems and sharing scarce skills such as engineers. Capacity can be targeted at individual or systematic level. For instance, a systematic intervention would be the installation of pre-paid meters, which would improve revenue collection and thus cash flow. Stakeholders noted the limited use of internships by municipalities and asked what reasons (cost, incentive or capacity shortcomings?) were inhibiting municipalities from making greater use of internships and developing partnerships for in-service graduate training. Relationships between local government and universities and the private sectors should also be strengthened, while communities and social entrepreneurs can be involved in implementation.

10. Conclusion

It is clear that consensus is beginning to emerge among stakeholders over options for improving the effectiveness of the LGFF. The next step is to look at what would be the best set of recommendations in order to overcome the problems of financing local government in the long term. The Commission will explore this further in the full workshop report, as well as in its future engagements with stakeholders. A draft technical report, with an initial set of recommendations and policy options, will be released for further consideration by stakeholders. Stakeholders will be able to raise concerns and question the recommendations put out by the Commission.